The Outlook for the U.S. Banking Industry: What Does the Experience of the 1980s and 1990s Tell Us?

By Kenneth Spong and Richard J. Sullivan

In many respects, the 1980s appear to be the worst decade in banking since the Great Depression, while the 1990s could be rated as the best. Over 1,100 commercial banks failed or needed FDIC assistance during the 1980s, and significant parts of the thrift industry became insolvent and had to be resolved, costing taxpayers $125 billion. In contrast, the banking industry began a dramatic recovery in the first half of the 1990s and has recently achieved record profitability, extremely low levels of loan losses, and the highest capital ratios since the early 1940s. As a result, the number of banks failing during the second half of the 1990s has averaged only four or five per year.

These two divergent experiences raise the question of what will happen during the next decade. One obvious forecast would be for recent favorable trends to continue, particularly since banks and the underlying economy have shown remarkable strength and resiliency in their recovery from the 1980s. The current environment is not without some concerns, however. Consumer debt has reached record levels, and a few sectors, such as agriculture, show signs of weakness. Also, bank supervisors have recently voiced concerns that bank credit standards are weakening. Moreover, the financial environment is changing rapidly with innovation, bank expansion and consolidation, and competition from new sources, thus opening the door for new problems.

What will happen next in the banking industry? This article examines the outlook for the banking industry over the next few years, focusing on whether the prosperity and tranquility of the 1990s will continue, or whether the industry faces a return of the banking problems of the 1980s. Because banks are in much better shape now than in the 1980s, the industry is unlikely to face the depth of problems suffered in the 1980s even if the economic environment becomes less favorable. Still, it appears that banks will be hard pressed to match their recent record performance.

The first section of this article gives a financial overview of the crisis of the 1980s and the recovery of the 1990s. The following sections compare and contrast the 1980s and 1990s in three areas: the macroeconomy, major industry sectors and borrowers, and the banking industry and its lending performance. Based on this historical comparison, the final section discusses the most likely outcome for banking in the coming years.

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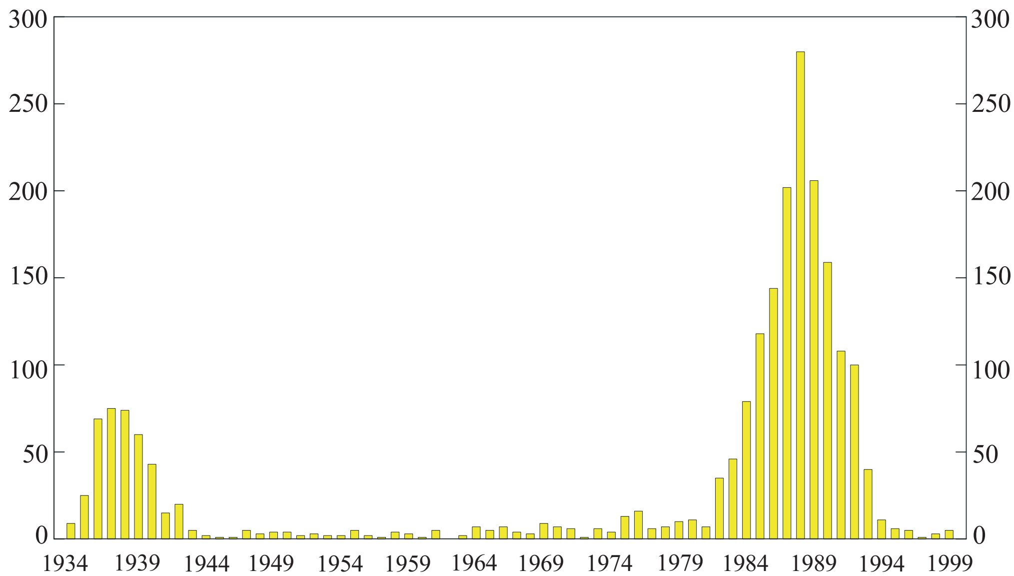
Chart 1
NUMBER OF U.S. COMMERCIAL BANK FAILURES
1934-99



Source: Federal Deposit Insurance Corporation.

I. CRISIS AND RECOVERY IN U.S. BANKING

Over the past two decades, the U.S. banking industry has taken the proverbial "roller coaster" ride. Banks in the 1980s suffered the most severe problems since the Great Depression. In fact, significant portions of the industry were at the forefront of virtually every economic and financial crisis of the decade, involving energy, agriculture, real estate, and commercial and LDC (less developed country) lending. Bank lending in the 1980s helped foster a boom-bust cycle that went well beyond the basic economic fundamentals in these areas, with each cycle typically ending with substantial lending losses and widespread banking failures. The 1990s have witnessed nearly the opposite outcome—a dramatic recovery followed by several years of record or near-record performance. This section reviews the general environment of the 1980s and 1990s and the major events that define each period.

The 1980s: A period of crisis

The 1980s represented a sharp departure from the previous 50 years. After the Great Depression, there were no serious banking problems over the next few decades. Bank failure rates were consistently low from the 1940s through the 1970s, and only in a few years did the number of failures exceed ten (Chart 1). This picture then changed significantly during the 1980s. More than 1,100 commercial banks failed or received federal financial assistance, representing nearly 8 percent of all banks operating at the beginning of the decade.

Thrift problems in the 1980s were even greater and were seldom resolved in a timely manner. Over 900 thrifts failed, representing 17.5 percent of all thrifts operating at the start of the decade. Moreover, many of these thrifts continued to operate while insolvent, due to the lack of insurance funds to resolve their problems. Roughly one of every five thrifts in operation during the 1980s was actually insolvent, with these insolvent institutions holding more than 30 percent of the thrift asset base.

The 1980s also ushered in a new era of financial innovation and experimentation in debt markets. Junk bonds, leveraged buyouts, commercial paper, money market mutual funds, derivatives, and asset securitization are just a few of the financial instruments and activities that became popular. These new financial instruments and expansion by nonbank institutions created greater competition for banks and greatly expanded access to credit for certain groups. Deregulation and the removal of many product restrictions and geographic barriers in banking and other financial services also played a major role in driving the credit boom and collapse of the 1980s.

Another important aspect of the 1980s was the presence of severe economic distress in certain industry sectors and regions of the country. Although the national economy remained sound throughout much of the decade, excessive optimism and subsequent debt problems were prominent in a number of sectors, including agriculture, energy production, real estate construction and investment, and international lending.

The 1980s collapse in farming was set up by booming agricultural conditions in the 1970s, when commodity prices, farm incomes, and farmland values all reached record levels. Plunging crop prices in the 1980s then set the stage for the farm crisis. The U.S. Department of Agriculture's crop price index, for example, dropped 36 percent. Sharply rising interest rates in the early 1980s also played a key role in bringing down farmers that had pursued aggressive borrowing strategies. Altogether, such problems led to the failure of nearly 300 agricultural banks from the late 1970s to the early 1990s (FDIC 1997).[1]

A similar pattern occurred in energy production. The price of crude oil soared from around $3 a barrel in the early 1970s to a peak of $37 in 1981, setting off a surge of energy exploration, speculation, and lending. A drop in prices to $10 a barrel in 1986 then set the stage for the oil patch crisis. The combination of collapsing oil and agricultural prices was particularly devastating to the Texas economy, where 425 banks failed and nine of the ten largest bank holding companies failed or had to be recapitalized in the 1980s (FDIC 1997).

Real estate construction and investment followed a similar boom and bust cycle during the 1980s. While part of this cycle can be traced to initially favorable economic conditions in California, Arizona, the Northeast, and the energy states, other factors were also important. Financial deregulation and more favorable real estate taxation in the early 1980s helped provide both the funds and the incentives for a real estate boom. The subsequent overbuilding and collapse in real estate values, along with a tightening of tax policies in 1986, then resulted in the thrift debacle and the failure of many banks, including several large institutions.

One final troubling event for banks in the late 1970s and 1980s was the LDC debt crisis. LDC lending had grown rapidly in the 1970s as many developing nations tried to finance more rapid economic growth and cover increasing oil prices and rising interest rates on dollar-denominated debt.[2] Major U.S. banks were also using overseas expansion and LDC lending in the 1970s as new profit opportunities in wake of increasing competition in their traditional lending markets. The final trigger to the LDC crisis was the very high level of U.S. interest rates in the early 1980s, coupled with a slowdown in export revenues for many LDCs. For U.S. banks, this crisis forced them to restructure and take significant write-downs on their LDC loans. Although no major bank failed because of LDC lending, the profitability of large U.S. banks was depressed throughout the 1980s.

The 1990s: Recovery and record performance

The events of the 1990s stand in stark contrast to those of the 1980s. The banking industry had to work its way through several leftover problems in the early part of the decade, but the remainder of the decade has been one of the best ever for banks.

The banking industry was slow to recover from the 1980s. Initially, banks faced the 1990-91 recession and a continued collapse in overbuilt real estate markets. Another early stumbling block was the "credit crunch," during which loan demand fell and banks became more cautious in an attempt to improve credit quality. From 1990 to 1993, 407 commercial banks failed.

Since 1994, the banking industry's performance has rebounded and climbed to remarkable heights. Only 31 commercial banks failed from the beginning of 1994 through the third quarter of 1999. For most of this period, bank profitability has been at or near record levels, while credit problems have been minimal.

In addition, banks have shown much greater resiliency to sectoral economic problems in the 1990s. Despite recent downturns in several sectors, banks have yet to fall victim to the types of problems that plagued the industry in the 1980s. In agriculture, the USDA's crop price index has fallen by roughly 30 percent over the last three years, which compares closely to the 36 percent decline in the 1980s. While more time may be needed to see the full effects of lower farm prices, most agricultural banks are still doing well. In the energy sector, crude oil prices plunged nearly 55 percent from the beginning of 1997 to early 1999—a decline similar to that of the 1980s (*Petroleum Marketing Monthly*). Few banks, though, have suffered serious harm from this, in part because oil prices have since recovered, but also because most oil patch banks are far more diversified than before. The recent Asian financial crisis also has some similarities to the LDC loan problems of the 1980, but unlike then, major U.S. banks have largely avoided foreign lending concentrations and have seen little effect on their credit quality.

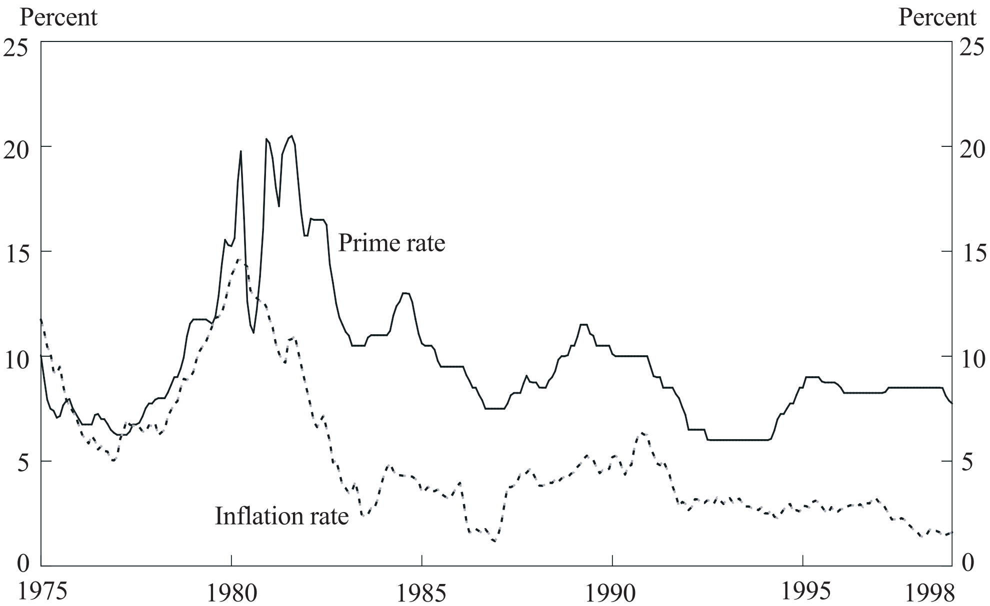
The banking environment in the 1990s has therefore been much different than in the 1980s. There are a number of reasons for expecting recent trends to continue, but there are also signs that some aspects of the 1980s could return. A closer look at the macroeconomy, individual sectors of the economy, and the banking industry during the 1980s and 1990s may help provide better insight into the outlook for banking.

II. MACROECONOMIC CONDITIONS AND THEIR EFFECT ON BANKING PERFORMANCE

A starting point in explaining the differences in banking performance between the 1980s and 1990s is the health of the overall economy. In a prosperous and growing economy, most borrowers have the income and resources to meet their obligations. On the other hand, in a declining economy, bank borrowers may face reductions in income and could struggle to make their debt payments.

One measure of economic conditions—the growth in real gross domestic product—is similar for both the 1980s and 1990s. Average annual growth during the 1980s expansion was 4.2 percent compared to 3.5 percent for the 1990s expansion period, with much of the difference being due to a much faster start to the 1980s expansion.[3] The expansions in both of these periods are also similar in length. The 1990s

Chart 2
INFLATION AND SHORT-TERM INTEREST RATES
United States, monthly



Notes: The prime rate is the rate on short-term loans charged by banks for their highest quality commercial borrowers, and is an average of daily rates, not seasonally adjusted. Inflation is measured by the percent change of the consumer price index for the preceding 12 months, seasonally adjusted.
Sources: Board of Governors of the Federal Reserve System and Bureau of Labor Statistics.

expansion just recently surpassed that of the 1980s in length and trails only the 1960s expansion as the longest in U.S. history (NBER).

Because of their similarity, these economic trends shed little light on why banking performance differed so dramatically in the 1980s and 1990s. The rapid start to the 1980s expansion might have been a factor behind some of the speculation and the credit boom in this period, but the continued prosperity does not explain why serious banking problems developed. One possible link is that prosperity often encourages people and businesses to become highly optimistic and less cautious in their financial behavior. To the extent this could be true in the 1990s, any credit imbalances have yet to show themselves.

Another key economic and financial variable influencing banking conditions and the decisions of bank borrowers is inflation. Inflation is an important variable because it determines the real value of loan repayments to banks and thus, at some point, is reflected in the nominal interest rates banks charge on loans. Inflation rates were much higher and more volatile in the early 1980s than in the 1990s (Chart 2). Inflation climbed rapidly in the late 1970s and early 1980s, then dropped just as rapidly. Since the mid-1980s, inflation has stayed relatively low.

Inflation directly affects interest rates, or the cost of borrowing. In response to rising inflation, the prime interest rate soared in the late 1970s and early 1980s. However, the adjustment of interest rates to inflation often lagged behind the inflation trends. Going into the 1980s, the prime rate was close to the inflation rate, thus putting the real interest rate, or the actual cost of borrowing, near zero. In fact, the effective cost of borrowing at this time was probably even below zero for many borrowers, since interest payments were generally tax deductible. Efforts to control inflation in the early 1980s soon led to rapid increases in the prime rate and in the real cost of borrowing. The volatility of interest rates in this period added to the uncertainty in borrowing and lending decisions.

This interest rate environment provides one possible explanation for the credit problems of the 1980s. The low real interest rates of the 1970s greatly reduced the effective cost of credit and gave bank customers and other borrowers a strong incentive to increase their indebtedness. As the real cost of borrowing rose dramatically in the following years, these higher debt loads then set the stage for debt repayment troubles and, in turn, for bank credit problems and failures. In addition, high interest rates in the early 1980s left many thrifts insolvent, based on their holdings of long-term loans granted at much lower rates. In contrast, U.S. banks, thrifts, and their customers have experienced much greater stability in real borrowing costs throughout the 1990s.

III. MAJOR INDUSTRY SECTORS AND BORROWERS

Another key to understanding the differences between the 1980s and 1990s is the financial condition of different bank customer groups, most notably businesses, farmers, the construction industry, and consumers. The ability of these customers to prepare for and withstand adversity played an important role in determining banking performance over the last two decades and will be an important consideration for the future. This section reviews a number of financial measures for these economic sectors and examines how these measures are related to bank performance in the 1980s and 1990s.

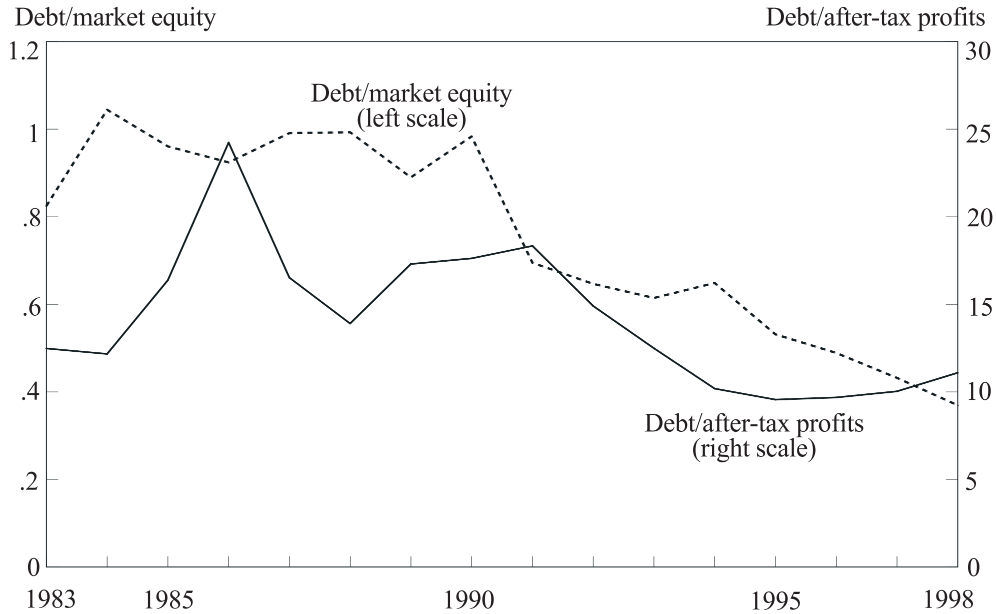
Corporate sector

Banks are an important source of short-term funds for businesses. As a result, the condition of banks should be influenced strongly by the health of the corporate sector. This linkage between bank and corporate prosperity helps explain why the banking industry did much better in the 1990s than in the 1980s. In general, corporate debt expanded rapidly in the 1980s, and corporations played a key role in the credit boom and collapse of this decade. In the 1990s, corporate borrowing has typically been more restrained, and better corporate finances are reflected in fewer bank credit problems.

How well businesses cope with adversity depends on their ability to service bank debt and other financial obligations. Two key measures of the ability of corporations to handle debt are the relationships between debt and corporate earnings and between debt and overall market value as based on stock prices. A debt-to-earnings ratio, for example, helps show whether businesses are generating enough earnings to repay their obligations and justify current debt levels. Debt-to-market equity ratios indicate how debt compares to the valuation placed on corporations by the market.

During the mid-1980s, the ratio of debt to corporate profits grew rapidly for nonfinancial corporations (Chart 3). In fact, over the entire 1980s expansion, corporate debt grew on average more than 11 percent annually, while after-tax profits increased at less than 6 percent. Consequently, many businesses were left with relatively fewer resources to repay a rising level of obligations. An eventual result of this trend may have been the 1990-91 recession and the

Chart 3
MEASURES OF DEBT CARRYING CAPACITY FOR U.S. NONFINANCIAL CORPORATIONS



Source: Board of Governors of the Federal Reserve System, Flow of Funds.

following "credit crunch," in which much of the business sector had to curtail expansion plans, cut back on existing operations, and take other contractionary steps.

These debt and profit trends have largely reversed themselves in the 1990s. Corporate debt in relation to earnings has fallen or remained steady throughout most of the 1990s and has generally been below the levels achieved during the 1980s. In percentage terms, corporate debt has increased just 6 percent annually, while corporate profits have risen at more than twice that rate. This turnaround presumably reflects successful efforts to cut costs, take advantage of technological progress, and meet growing levels of domestic and foreign competition.

These figures suggest that most businesses in the 1990s have been more able to handle their debts than they were in the 1980s. A concern, though, is that corporate debt recently appears to be increasing in relation to profits. On an aggregate basis, corporate profits are flattening out, while the growth in debt is beginning to accelerate at a pace reminiscent of the 1980s.

Debt-to-market equity ratios also suggest greater debt problems in the 1980s. This ratio has fallen significantly during the 1990s, reflecting in part a rapidly rising stock market. The market value of the corporate sector thus appears to be supplying more support to corporate borrowings in the 1990s as compared with the 1980s. Even a substantial market correction would still leave debt-to-market equity ratios in much better shape than in the 1980s.[4]

Overall, corporate businesses in the 1990s appear to have done a better job of controlling debt and maintaining their profitability and market value. In some ways, the decade of the 1980s may have been unique in terms of its credit boom and collapse. A variety of new debt instruments became popular then, and the inflationary environment of the previous decade, along with the popularity of leveraged buyouts, helped encourage businesses and investors to favor the use of debt markets over equity markets. Since then, many changes have occurred in the economy. In particular, relatively low interest rates and healthy profit trends are serving to make current debt levels more manageable than in previous years. This favorable picture appears to have provided a strong underpinning for the banking industry, assuming corporate borrowing does not accelerate over the next few years and corporate profits continue to be strong.

The agricultural sector

Banks also play a critical role in financing the agricultural sector. Consequently, farm industry finances are often closely correlated with the health of many rural banks. This relationship was most obvious in the 1980s when farmers and rural bankers suffered through one of the most severe agricultural downturns in U.S. history. Farming conditions have generally improved in the 1990s. While prices for grain and livestock have recently fallen, these declines have yet to be felt significantly by banks.

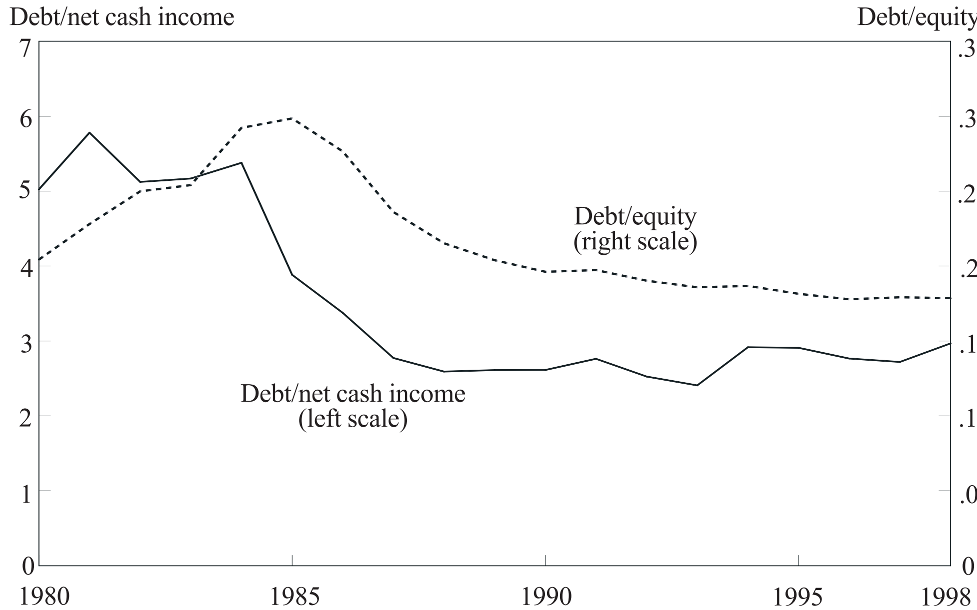
A key step in comparing farm finances in the 1980s and 1990s is to examine debt levels in farming and the flexibility of farmers in managing their debts. Two measures of the debt carrying capacity of U.S. farmers are debt-to-net cash income ratios and debt-to-equity ratios. The first ratio measures how much debt farmers have in relation to the earnings they generate—earnings which provide the funds for covering interest obligations and debt repayments. The second ratio measures how well farmers keep debt levels in line with the overall equity they maintain in their farming operations.

Farm debt has declined substantially since the 1980s in relation to both net cash income and equity (Chart 4). For example, total farm debt was nearly six times farm income in the early 1980s, but in the late 1990s has fallen to less than half that amount. Also, average farm debt-to-equity ratios have fallen from almost 30 percent in the mid-1980s to less than 18 percent in 1998, leaving farmers less exposed to the type of debt problems that plagued them and their bankers in the 1980s.

Several other factors also point to better farm finances in the 1990s. Interest rates are low and have fluctuated far less than in the 1970s and 1980s. With low unemployment in many areas, off-farm income has become an important and stable source of financial support for many farmers. In addition, most farmers are now following more conservative expansion policies. In contrast to the last agricultural cycle, few farm advisors are advocating that farmers borrow heavily to expand.

While the overall outlook in the 1990s has been relatively more favorable, this decade may be closing with some disturbing trends for farmers and their bankers (Westcott and Landes). A major share of the decline in debt-to-equity ratios may be due to increasing farmland values over much of the 1990s. Should low commodity prices continue and eventually deflate land prices, debt-to-equity ratios could rise substantially. Also, competition from abroad has been increasing as developing countries adopt more advanced agricultural techniques and other countries, such as Brazil, find ways to open more land to farming. Foreign competition could also keep U.S. prices depressed if currencies in some of

Chart 4
DEBT CARRYING CAPACITY OF THE U.S. FARM SECTOR



Source: U.S. Department of Agriculture, Economic Research Service.

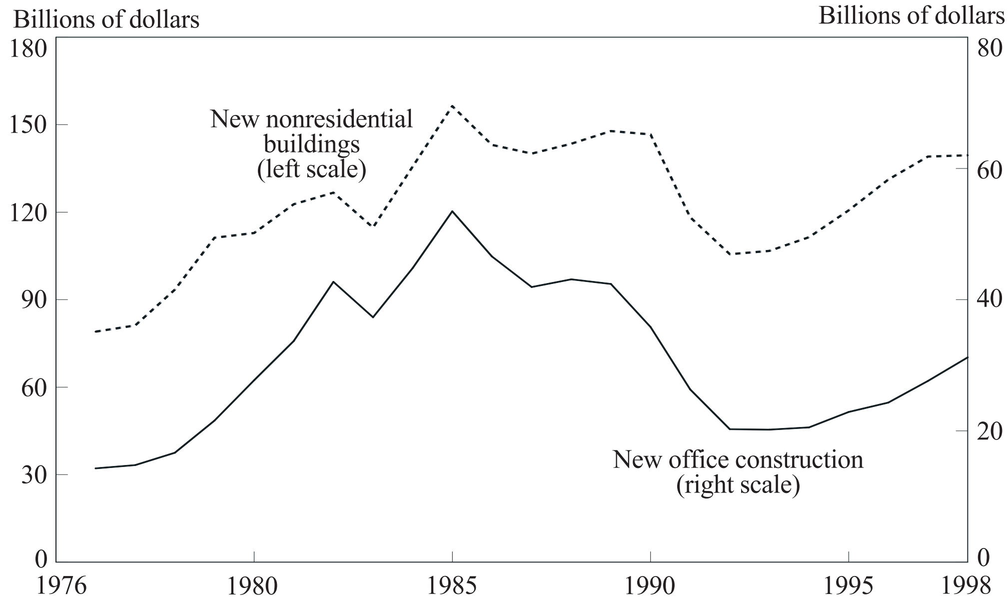
the exporting countries remain weak. An additional concern is that government support payments are scheduled to decline further under the 1996 farm legislation.

Thus, the trends in farm finances generally reflect the economic problems of the 1980s and the recovery in the 1990s. Debt was much higher relative to farm income and equity in the 1980s, which would help to explain many of the debt problems and bank lending losses that arose during the farm crisis. Since then, farmers and rural bankers have generally avoided the speculative attitudes that brought on the earlier problems. Some long-term concerns remain, however, such as how a continuation of low prices and a drawn-out contraction could affect the farm economy and the ability of farmers to repay bank loans.

Real estate conditions

Banks are major providers of funds for real estate construction and interim financing. Also, while much of the long-term financing for residential real estate now passes through the capital markets, banks still originate a sizable portion of this debt and hold substantial amounts of it on their own balance sheets. Real estate lending activities were at the forefront of many of the banking problems of the 1980s and early 1990s—a period during which the real estate industry experienced one of its most pronounced cycles in U.S. history. Since then, the real estate industry has followed a much more stable course, and banks have suffered far fewer problems in their real estate lending than in the 1980s.

Chart 5
ANNUAL VALUE OF NEW U.S. NONRESIDENTIAL BUILDINGS AND NEW OFFICE CONSTRUCTION
Constant (1992) dollars



Source: U.S. Census Bureau.

During the 1980s, real estate construction and investment proved to be extremely volatile segments of the economy, with soaring construction activity in the first half of the decade, followed by a sharp decline through 1991 (Chart 5). The overbuilding associated with the peak construction years and the subsequent declines in property values became a central element in the thrift crisis. Banks with significant real estate lending exposures during this period suffered heavy losses and, in several notable cases, failed.

This real estate volatility stemmed from a number of factors. First, rising interest rates had depressed construction activity in the late 1970s and early 1980s, and subsequent interest rate declines helped spark a surge in new construction. Also, the 1981 tax changes allowed real estate investors to begin using an accelerated rate of depreciation for real property, thus helping to create a speculative environment in commercial real estate. The 1986 tax reforms removed many of these "tax shelter" incentives, however, and helped to send the industry into a downward spiral. Other factors behind volatile real estate conditions included the boom and bust conditions in the energy industry, the end of the New England "economic miracle," the easing of several real estate lending restrictions for banks and thrifts, and a jump into commercial real estate lending by problem and failing thrift institutions. In response to these conditions, a number of major banks that were active in commercial real estate lending failed during the 1980s and early 1990s in such areas as Texas, other energy states, and New England.[5]

Since 1992, nonresidential building and new office construction have followed a steadier pace. Other measures of real estate market conditions also appear more favorable for the 1990s. While metropolitan office vacancy rates approached 20 percent on a nationwide basis during the 1980s real estate collapse, this vacancy rate has recently dipped below 10 percent (CB Richard Ellis). As a result, most new commercial construction appears to be readily absorbed by local markets.

A number of factors have contributed to the more stable real estate conditions of the 1990s. First, policymakers have been strongly committed to avoiding a repeat of the 1980s economic environment, in which significant fluctuations in interest rates, inflation, and real estate taxation contributed to real estate volatility. Also, a number of bank and thrift regulations, such as real estate loan-to-value ratios and appraisal standards, have been reimposed or tightened in an effort to prevent the type of lending problems that arose in the 1980s. Other favorable factors include a sounder thrift industry in the 1990s and increased market discipline as more real estate financing shifts to the capital markets through securitization, REITs, and other innovations.

Consequently, real estate markets and lending are in much better condition now than in the 1980s. A few areas of concern remain, though, such as selected markets with high vacancy rates, other markets where much new construction is in progress, and the likelihood that an economic downturn could lead to higher vacancy rates and lower property values.

Consumers

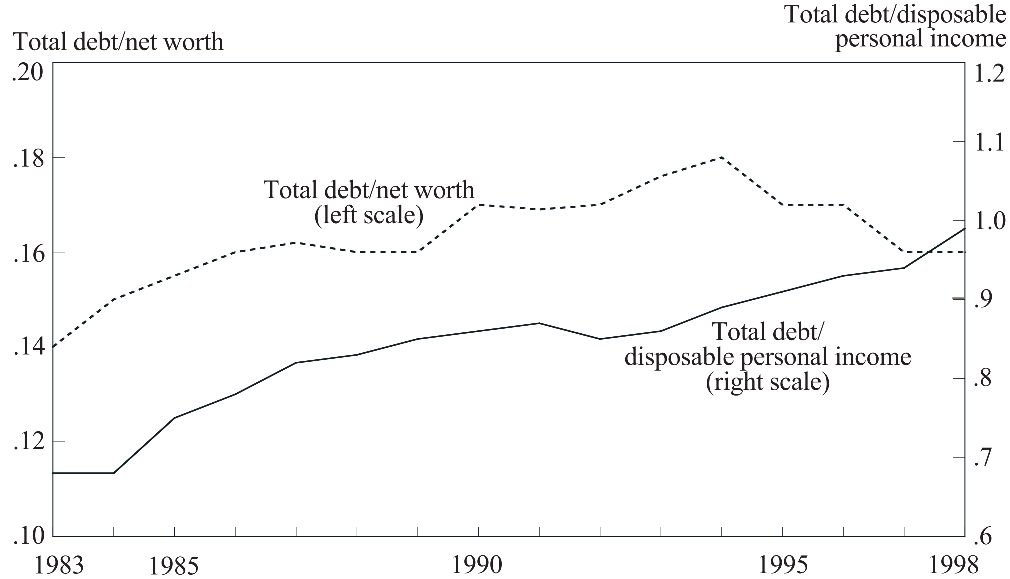
Consumers represent another important segment of the marketplace and customer base of banks. Consumer spending, moreover, is a driving force behind U.S. economic growth and the profitability of many banks. Both the 1980s and the 1990s have seen significant growth and expansion in consumer credit. Over both decades, consumer credit has grown much more rapidly than several corresponding measures of consumers' debt repayment capacity. In spite of this apparent deterioration in credit quality, consumer debt has not resulted in any significant banking problems in the 1980s or 1990s.

Consumer credit quality and its implications for the banking industry can be judged by such factors as the volume and cost of consumer debt in relation to the personal income and net worth of consumers. For example, higher income, higher net worth, and lower interest rates all help increase a consumer's ability to repay debt and support spending.

The strong growth of consumer credit in the 1980s and 1990s has left consumers with a rising debt burden relative to their incomes (Chart 6). Household debt increased 11 percent annually in the 1980s expansion period and 6.6 percent annually in the 1990s expansion. These increases in debt exceeded the growth in household income over the same periods. Consumer debt in relation to household net worth has also risen throughout much of the 1980s and 1990s, although a rapid growth in household net worth in the second half of the 1990s has helped to reverse this pattern.

Another indicator of household debt conditions, consumer bankruptcies, also points to a worsening of credit quality in the 1990s. Nearly 1.4 million consumers filed for bankruptcy in 1998. This number was more than four times the highest annual rate reached in the first half of the 1980s and more than twice that of any single year in the 1980s (Chart 7). This dramatic increase in bankruptcies during favorable economic conditions would seem to imply a significant overuse of credit by many consumers. Other factors, such as a declining stigma attached to personal bankruptcy, may have also played a role in the bankruptcy trends. For

Chart 6
DEBT CARRYING CAPACITY OF HOUSEHOLDS



Source: Board of Governors of the Federal Reserve System, Flow of Funds.

Chart 7
CONSUMER BANKRUPTCY FILINGS

Source: Administrative Office of the U.S. Courts.

bankers and other consumer lenders, today's high level of consumer bankruptcies raises the question of how high the number of bankruptcy filings and related loan losses might go should economic conditions worsen.

IV. THE BANKING SECTOR—IMPROVED RISK MANAGEMENT AND A NEW REGULATORY ENVIRONMENT

The banking industry has made a dramatic recovery from the 1980s by virtually every measure of performance. Profitability has been at or near record levels, capital is at its highest point in many years, and loan quality has improved significantly. A number of factors may have played an important role in this resurgence. As shown in the previous sections, economic conditions have been extremely favorable in the 1990s, and individual industry sectors and bank customer groups have typically controlled their debt levels and improved their earnings and overall resources. In response to the problems of the 1980s, many banks have also attempted to improve their risk management practices and have become more diversified. In addition, the regulatory framework has changed, partly as a result of the previous problems, but also because of ongoing and revolutionary developments in the banking industry itself. This section discusses the changing performance of banks in the 1980s and 1990s and the possible factors behind this improvement.

The condition of banks in the 1980s and the 1990s can be compared using a number of different measures, including profitability, capital protection, and the volume and riskiness of lending activities. Bank profitability has been much higher in the 1990s than in the 1980s (Chart 8). In fact, return on average assets for the entire U.S. banking industry reached a record of 1.30 percent in 1997, nearly twice the typical level achieved in the 1980s. These earnings differences reflect the variety of problems banks faced during the 1980s expansion, including LDC lending problems, the agricultural and energy crises, and real estate overbuilding. In contrast, U.S. banks have not faced any sustained problems in the 1990s, and such events as the Asian financial crisis and the agricultural slowdown have yet to have more than a moderate effect on bank earnings.

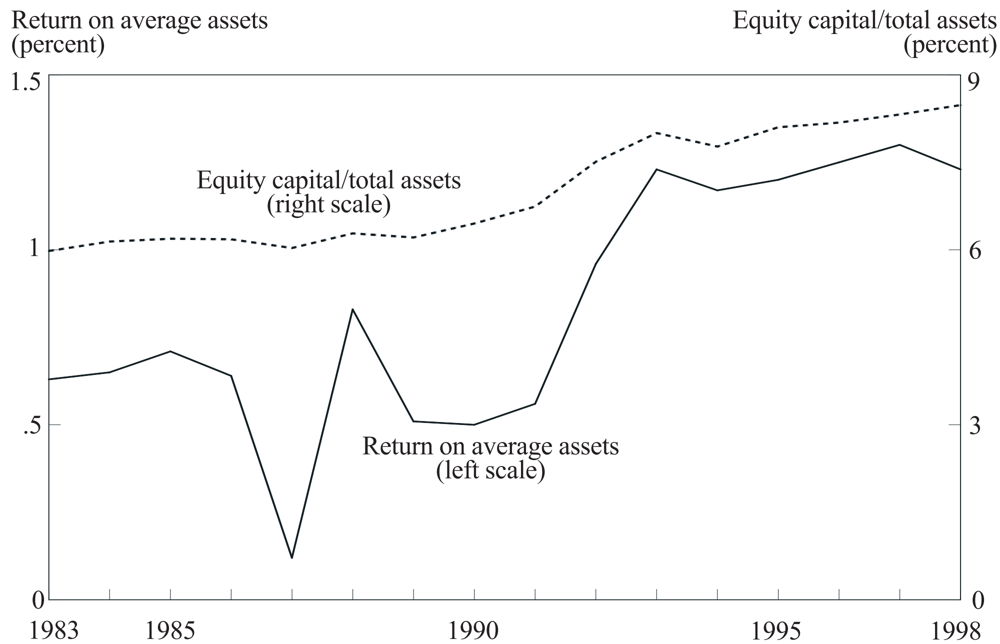
In the 1990s, banks are also doing a better job of maintaining and increasing capital. Since the beginning of the decade, banks have gradually built up their capital and now have equity capital ratios that are more than two percentage points higher than in the 1980s (Chart 8). On an industrywide basis, bank equity capital ratios are now at their highest level since 1941. The trend toward higher capital can be attributed to such factors as better earnings in the 1990s, fewer banking and economic problems, and favorable conditions in equity markets.

Regulation, in the form of higher capital requirements, has also played a major role. The adoption of risk-based capital standards in the late 1980s, followed by the prompt corrective action capital guidelines in the early 1990s, have given banks strong incentives to increase their capital levels.

Nevertheless, while bank capital is important in absorbing losses and supporting bank operations, it is not a perfect guarantee against serious problems. Many banks that failed in the 1980s began with healthy capital levels but encountered severe downturns in their region. Moreover, bank capital must now cover more off-balance sheet activities than ever before and a possibly wider range of risks.

The next point of comparison—banking risk—is of interest due to the problems many banks encountered in the 1980s. The major risk for most banks lies in their lending activities. While it is difficult to measure and compare risk exposures in bank lending, it is possible to

Chart 8
PROFIT AND EQUITY CAPITAL FOR U.S. BANKS
Weighted average



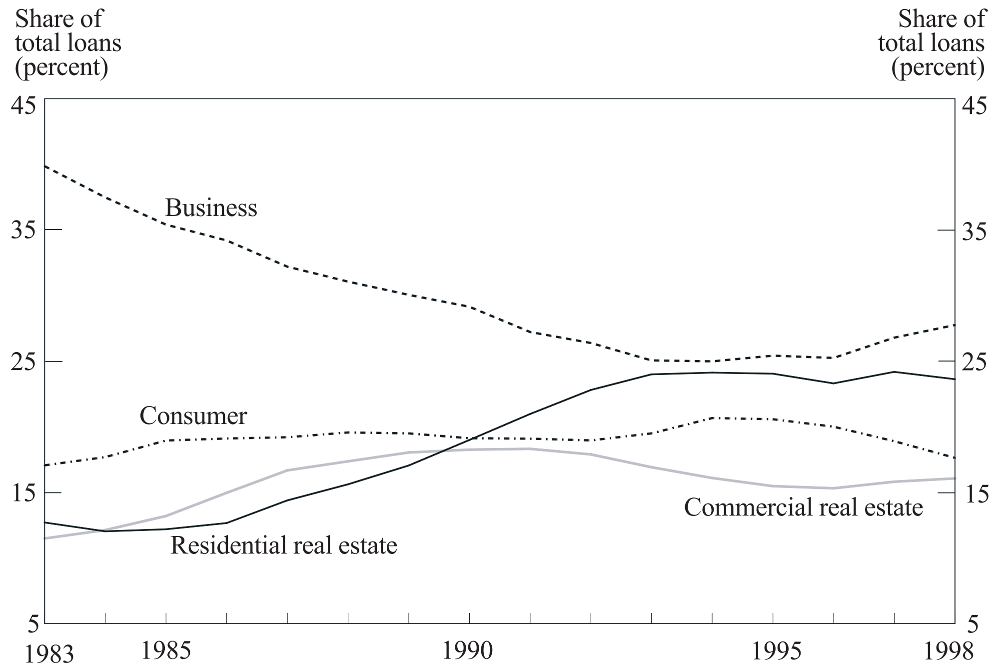
Notes: Equity capital does not include loan loss reserves. An unrealized loss of -.20 percent was deducted from equity capital in 1994 in response to new accounting practices.
Source: Reports of Condition and Income for banks.

examine the types of lending at banks, volume of lending relative to other banking activities, and the amount of problem loans.

The focus of bank lending has experienced a number of notable changes over the last two decades. From the beginning of the 1980s expansion to 1998, business lending fell from more than 40 percent of the bank industry's total lending portfolio to less than 28 percent (Chart 9). At the same time, real estate lending jumped from under 26 percent of the overall loan portfolio to 41 percent. This increased real estate lending involved both commercial and residential real estate in the 1980s, but only residential real estate has taken on a more prominent role in the 1990s. The shift away from business lending reflects, in part, a movement by large, highly rated corporations toward the use of commercial paper and other credit market sources. The increase in real estate lending to fill this void suggests than bank lending may have become more risky, particularly with regard to the expansion of commercial real estate lending activities in the 1980s. Consumer lending has maintained much the same position in bank loan portfolios, except for a slight increase in the mid-1990s.

Two other lending comparisons can be drawn for the 1980s and 1990s using bank loan-to-asset ratios and the level of problem loans. Loan-to-asset ratios provide one measure of a bank's potential exposure to credit quality problems. Although a high loan-to-asset ratio

Chart 9
TYPES OF LENDING AT U.S. COMMERCIAL BANKS
Weighted average



Source: Reports of Condition and Income for banks.

by itself does not necessarily indicate credit problems, several studies have found this ratio to be one of the best predictors of bank failures.[6] The loan-to-asset ratios of banks reached their peak in the late 1980s and have remained lower on average throughout the 1990s (Chart 10). These differences, though, are fairly small and might be explained in part by the increased use of securitization as a means of moving loans off the balance sheets of banks.

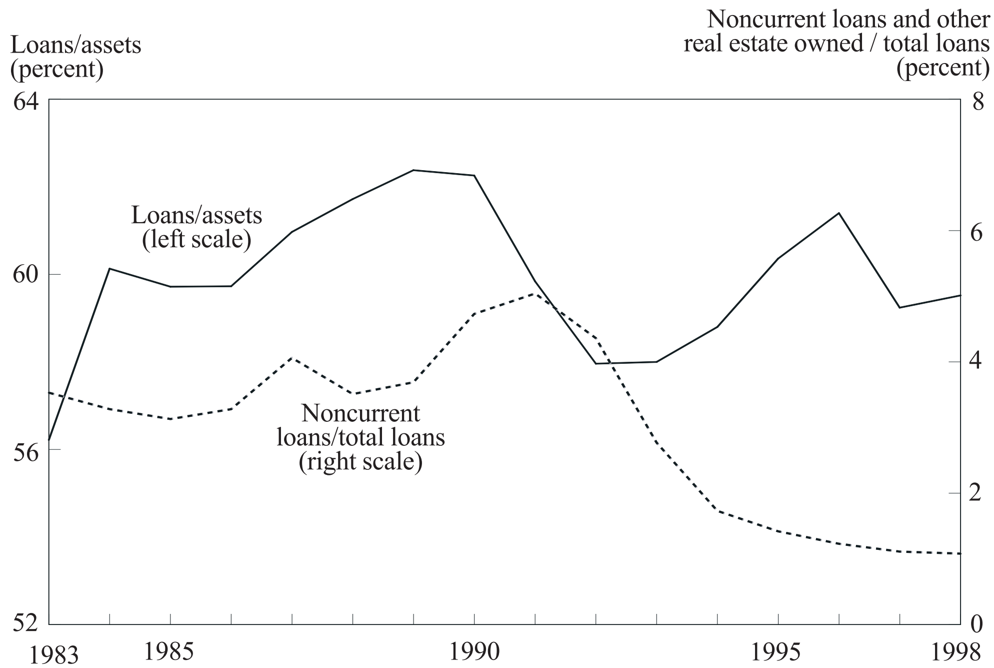
Noncurrent loans provide a more direct measure of loan quality. Banks now have much lower levels of noncurrent loans than in the 1980s and early 1990s (Chart 10). For instance, the noncurrent loan ratio for 1998 was less than one-third the typical ratio during the 1980s expansion. This pattern also holds true for such individual loan categories as commercial loans, real estate loans, and agricultural loans (FDIC 1995-99). In each of these lending categories, loan charge-off and delinquency rates have dropped significantly from their peak levels in the 1980s.

The exception to these improving credit quality trends is consumer lending. Bank credit card loans now have charge-off rates above those during the 1980s, and delinquency rates on both credit card debt and other consumer loans have been rising over the past few years. There are also other indications that bank consumer credit quality has deteriorated. Access to consumer credit has expanded rapidly at banks, and high-risk forms of consumer lending are gaining greater prominence in bank portfolios as

Chart 10

RATIO OF LOANS TO ASSETS AND NONCURRENT LOANS AND OTHER REAL ESTATE OWNED TO TOTAL LOANS FOR U.S. BANKS

Weighted average



Source: Reports of Condition and Income for banks.

well. For instance, credit card lines or unused commitments have grown quickly at banks, reaching a figure of more than $2 trillion in 1998—a fourfold increase since the early 1990s (FDIC 1999). Banks are also using securitization as a means of further increasing access to consumer credit. In addition, a significant number of banks are jumping into riskier forms of lending, such as subprime and high loan-to-value loans (Saunders; DiNapoli and Greenspan).

The overall improvement in bank credit quality can be attributed to the lengthy economic expansion of the 1990s and to the steps that many bank borrowers have taken to improve their earnings and control debt levels. At the same time, though, many banks have also implemented better risk management practices and adopted new and better tools for measuring and controlling risk. These include greater use of internal credit rating systems, risk models, risk limits and internal controls, and hedging activities. In addition, a significant portion of the banking industry has become more diversified as well, particularly on a geographic basis. Since the start of the 1980s, almost all of the regulatory barriers limiting bank expansion within states and across state lines have fallen, thus paving the way for rapid geographic expansion and consolidation in the banking industry. Other changes that may have contributed to improved credit quality include new loan-to-value guidelines and appraisal standards in real estate lending, the tightening of other regulatory provisions, better discipline from investors and capital markets, and the removal of failing thrift institutions from the competitive picture.

By most measures of performance, banks have improved substantially since the 1980s. Earnings are now at or near record figures, and most banks have capital levels that would provide much support during a downturn. Banks also have generally succeeded in managing credit risk and bringing down their levels of loan charge-offs and noncurrent loans. However, these risk-management efforts have yet to be tested in a severe downturn, and in some areas, such as consumer lending, banks already show signs of weakness.

V. OUTLOOK FOR THE U.S. BANKING INDUSTRY

A key question in the outlook for the U.S. banking industry is whether banks will continue to perform as well as they have in the 1990s or revert to another round of problems like those of the 1980s. The answer to this question is likely to depend on general economic trends, the health of individual sectors of the economy, and the success of banks in responding to future challenges.

The outlook for the banking industry will first be influenced by the overall economy. The macroeconomy was an important factor in the strong performance of banks and many industry sectors in the 1990s. To the extent that the economy continues its recent path and few sectors or regions are left behind, the banking outlook should generally correspond to that of the 1990s, particularly if overoptimism and debt imbalances can be avoided.

The economy could easily take another direction, though, especially since the current expansion is already one of the longest on record. One alternative path—rising inflation and interest rates—could affect banks in several ways. Consumer credit delinquencies would certainly increase as the cost of credit rose, although most consumers and banks appear to have the resources to handle the resulting credit problems. A more serious problem might arise if consumers were forced to curtail their spending, leading to a broader business downturn and declining corporate earnings. Rising interest rates could also lead to a declining stock market, which, in turn, could lower the net worth and spending of consumers and the level of business investment, further accentuating any downturn.

A downturn led by cutbacks in consumer spending would obviously result in notable declines in corporate and bank earnings and increased failure rates. However, both the corporate and banking sectors appear to be better prepared for this type of downturn than in previous years, based on current corporate debt loads, bank capital levels, and better risk management practices in banking. Consequently, unless a downturn is severe, the outcome would still be much more favorable than in the 1980s.

Regarding particular sectors or regions of the economy that might prove to be a problem for the banking industry in the future, two stand out—agriculture and the consumer sector. The farm sector could continue to face lower commodity prices for several years, due to increased foreign production and further improvements in production technology. However, farming has not been hit by the same speculative fever that brought on its collapse in the 1980s. Also, consolidation in farming and better farm practices and finances are leading to more efficient farms that can adapt to and survive a variety of threats. Congressional appropriations have further helped to maintain farm income and support farmland prices over the last two years. This suggests that farmers and agricultural banks may experience greater problems than they have at any point in the 1990s, but they are unlikely to fall as far as they did in the 1980s.

The consumer sector is a concern because of rising consumer debt levels. A strong economy and high employment rates in the 1990s have helped postpone any problems in this sector, but the consequences of high debt levels may be difficult to avoid over the next few years. Many consumers have adequate resources to support their borrowing, but a growing number do not. Household savings rates have fallen significantly over the past few years, and much of the growth in household net worth has come from a rising stock market. For banks that serve a diversified group of customers and have maintained their credit standards, consumer lending is not likely to pose a serious problem. However, for others with lower consumer lending standards or a concentration in subprime credits, an economic downturn and rising unemployment could cause significant loan losses. Although such banks may constitute only a small part of the banking system, consumer credit problems could have a much broader effect if consumer spending is significantly curtailed and business profitability declines.

The business and real estate sectors could also have isolated problems, most notably if corporate earnings flatten out or decline and real estate markets do not closely match construction to demand. It is conceivable that these potential problems could become more severe and follow a highly cyclical path. For example, current prosperity could possibly lead to rapidly rising optimism and overinvestment in either sector, combined with excessive debt expansion. This debt expansion, in turn, could set the stage for a more severe decline. In general, though, these two sectors have done a much better job of generating earnings, controlling debt, and avoiding excessive optimism and overbuilding compared with the 1980s. Consequently, both the business and real estate sectors appear less likely to experience a severe decline.

Overall, the potential problems facing banks from the macroeconomy and from individual sectors of the economy are unlikely to match those of the 1980s. Banks will begin the next decade with higher capital than in previous years, far fewer credit troubles, and record earnings levels. As a result, the banking industry should be in a better position to deal with any problems that might occur. These factors therefore suggest that bank performance over the next few years is unlikely to mirror that of the 1980s.

At the same time, though, banks may find it difficult to keep up the pace of the last few years. Economic conditions, interest rates, and other factors are unlikely to remain as favorable. Apart from their traditional lending activities, banks will also face a host of new challenges over the next decade, including further banking consolidation, growth in electronic banking, greater competition from nonbank sources, the merging of banking with the securities and insurance industries, new financial instruments, and the need to manage risks more closely in this rapidly changing environment. The success of banks in dealing with these challenges will play a large role in how well banks do in the future.

ENDNOTES

[1] In these bank failure statistics, agricultural banks are defined as those in which agricultural loans make up at least 25 percent of total loans and leases.

[2] For more information on the LDC debt crisis and its effect on large U.S. banks, see FDIC 1997.

[3] Many of the charts in this section will make comparisons over the 1980s and 1990s expansion periods. Since the 1980s expansion began with the first quarter of 1983 and the 1990s expansion began with the second quarter of 1991, the years 1983 and 1991 will be used as the starting points for comparing these two periods.

[4] Corporate debt-to-net worth ratios, which relate debt obligations to the volume of unencumbered resources supporting the debt, show a different trend during the 1990s than the other debt measures. For nonfinancial corporations, the aggregate debt-to-net worth ratio rose throughout the 1980s. However, unlike the other measures, this ratio continued to increase in the early 1990s and has since remained above the levels achieved in the 1980s. While this debt relationship is not consistent with the greater financial problems that corporations encountered in the 1980s, it could indicate that businesses are becoming more adept in their use of resources, capital, and risk management practices.

[5] A more detailed description of the real estate collapse of the 1980s and its effect on banks and thrifts can be found in FDIC 1997.

[6] For examples of such studies, see Belongia and Gilbert 1990 and FDIC 1997.

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